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No. 280

In the Supreme Court of the United States

OCTOBER TERM, 1935

SAMUEL A. SALVAGE, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 28–32) is unreported. The opinion of the Circuit Court of Appeals (R. 74–78) is reported in 76 F. (2d) 112.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 25, 1935. (R. 78.) An order granting an extension of time thirty days from

June 25, 1935, for filing a petition for certiorari was issued June 25, 1935. (R. 79.) The petition for a writ of certiorari was filed July 25, 1935, and granted October 14, 1935. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the Circuit Court of Appeals erred in holding that stock of the Viscose Company, subject to a gradually expiring option to repurchase at par, had a fair market value not in excess of its par value as of the date of acquisition by the petitioner.

STATUTES AND OTHER AUTHORITIES INVOLVED

The applicable statutes and other authorities involved are set forth in the Appendix, pages 23 to 26, to the brief filed by the Commissioner in *Guy T. Helvering, Commissioner of Internal Revenue* v. *Samuel A. Salvage,* No. 173.

STATEMENT

The essential facts are set forth in the brief filed by the Commissioner of Internal Revenue in No. 173 and, in the interest of brevity, will not be repeated here.

SUMMARY OF ARGUMENT

Where the owner of stock in a corporation contracts with it that it shall have the right to repurchase from him or his nominees such stock at a

certain price within a certain time, agreeing on behalf of himself, his heirs, executors, administrators, and assigns to procure for and deliver to the corporation such stock for repurchase at that price within that time, the fair market value of the stock while subject to such right of the corporation is the price at which the corporation has the right to repurchase. To ascribe to such stock while subject to such option to repurchase, a market value in excess of the agreed repurchase price would ignore the value of the option.

The court below concluded as a matter of law that the value of the stock subject to the option was the repurchase price fixed in the option agreement.

ARGUMENT

The sole question presented in this case is whether the court below erred in holding, with respect to the five-sevenths of the stock subject to an option to repurchase, that its fair market value when received in 1922 was not in excess of $100 per share, the price at which it could be repurchased under the option agreement.

If that was the fair market value of such five-sevenths in 1922, such market value being not greater than the actual cost of such five-sevenths to taxpayer at that time, there was no difference between the cost and fair market value to treat as 1922 income to taxpayer, whether under Treasury Decision 3435, II–1 Cumulative Bulletin 50, promul-

gated February 7, 1923, or otherwise. There is, therefore, no foundation or room for the taxpayer's position that he received or was chargeable with returnable income on such five-sevenths in 1922.

Moreover, upon the unfounded assumption that the taxpayer did receive or was chargeable with returnable income on such five-sevenths in 1922, the fact is that he did not return any such income for 1922. If this Court should sustain the Government's position in No. 173 that the taxpayer is estopped to claim that the basis for determining the gain from the redemption of the stock in 1929 is the fair market value of such stock when acquired in 1922, then the question presented herein is no longer material.

Under the terms of the agreement (R. 54–55) the corporation was given the right to repurchase at par ($100) five-sevenths of the stock during 1923, four-sevenths during 1924, three-sevenths during 1925, two-sevenths during 1926, and one-seventh during 1927. Therefore, only two-sevenths of such stock was received outright by the taxpayer in 1922. The other five-sevenths was received subject to an option to be repurchased at $100 per share, the price paid by the taxpayer for the stock. It would be manifestly unreal to ascribe to such stock a market value in excess of $100, when at the same time the stock was subject to an option to repurchase at that price, and to do so would assign no value to the option.

The fact that the option subsequently expired unexercised is irrelevant to the fair market value of the stock in 1922. While "the event is always a great teacher", that value must be determined as of that time in the light of facts then known, future possibilities being given only such weight as then reasonably would have been accorded them as a foundation for action by one then purchasing the stock subject to the option. "Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future; and the value is no less real at that time if the prophecy turns out false than when it comes out true." *Ithaca Trust Co.* v. *United States*, 279 U. S. 151, 155. No one, in 1922, contemplating purchasing the stock with knowledge of the option reasonably could or would have discounted the contingency that the option might be exercised by the corporation which had it. For the purpose of then estimating value the anticipation that the option would be exercised was exclusively reasonable; and only reasonable prophecy can be indulged. See *Robertson* v. *Routzahn*, 75 F. (2d) 537, 539 (C. C. A. 6th).

Nor is it relevant whether in 1922 a bona fide purchaser for value of the stock subject to the option might have acquired it from the taxpayer without notice of the option; for the issue is the fair market value to the taxpayer in 1922 of his stock and not the fair market value of similar stock of

the same corporation owned by others and subject to no option. The taxpayer cannot be heard to assert a market value premised upon the assumption that he had the power, as distinct from the right, so to dispose of the stock as to render it impossible for him to deliver the stock to the corporation if and when it should exercise its option. It is likewise irrelevant whether the intention of the taxpayer and the corporation was that the option should not be exercised so long as the former continued in the service of the latter and observed his agreement not to compete; for the contract places no such restriction on the right of the corporation to exercise its option. It was at all times until the option expired free to exercise it notwithstanding the taxpayer remained in the employ of the corporation and refrained from competition.

The taxpayer argues that the option agreement should not be taken into consideration in determining the fair market value in 1922 of the stock subject to the option, citing a number of cases in which there were restrictions against selling the stock for a certain period or against selling it to others without first offering it to certain parties or to other stockholders. But in those cases there was no restriction upon the price at which the stock was to be sold. Here the agreement named a fixed repurchase price and the fair market value of five-sevenths of the stock could not exceed that amount.

It is urged (Br. 27) that as the options expired the additional value came into the possession of the taxpayer, so that prior to the year 1929 he owned all of the stock subject to no restriction. But the effect of the expiration of the options was merely to increase the value of the stock in the hands of the taxpayer. There was then no realized gain. This being true, he may not claim that the market value of the stock, as and when freed from the option, is the proper basis for determining the gain from the redemption of the stock in 1929. Moreover, his case is based upon the theory that he realized income in the year 1922 to the extent of the difference between the cost of the stock to him and its then fair market value.

A similar case is *Wilson* v. *Bowers*, 57 F. (2d) 682 (C. C. A. 2d). There a decedent agreed not to sell or assign his shares without first offering them to his nephew at $6.66⅔ per share, and if the nephew did not accept, to one Betts. The agreement further provided that upon the death of the decedent they should have the right for a period of four months after the qualification of the executors to purchase the stock at the same price. In holding that the value of the stock was the amount for which it was subject to purchase under the option the court said (pp. 683–684):

> Since the contract was specifically enforceable, it seems obvious that the sale value of the stock during the testator's life could have been no more than the low price at which

> he was obliged to offer it, first, to Franklin Wilson, and then to Betts; nor could his executors have sold it for more, unless both the option holders had allowed their options to lapse. * * * Nor do we see the force of the appellant's argument that the holder of an option has no equitable interest in the property until the option is exercised. Williston, Contracts (2d Ed.) § 61. Granting this and accepting the appellant's analysis of the legal relations created by an option, the option holder's power to create a contract enforceable in equity was as effective to depress the value of the option giver's interest in the property subject to the option as would be the contract itself when created. So long as the option here involved was outstanding, the property could not be sold for more than the option price.

See also *Markle* v. *Commissioner*, 10 B. T. A. 763. There the Board held that the price at which stock could be purchased under an option was its fair market value.

The taxpayer in his brief (pp. 23–24) contends that the *Wilson* case, *supra*, is distinguishable for the reason that it involved estate taxes, whereas this case involves income taxes. But the fair market value of stock for estate-tax purposes is the same as fair market value for income-tax purposes.

The taxpayer also contends that the court below was without authority to find that the value in 1922 of five-sevenths of the stock was the option price

of $100 per share. The determination of the market value of the stock in 1922 was not contrary to any finding of the Board of Tax Appeals, because the Board found it unnecessary to determine the question, having held that the taxpayer acquired the stock by purchase and in no sense as compensation for services rendered the company. In determining that five-sevenths of the stock had a market value of $100 per share in the taxpayer's hands in 1922, the court below was deciding a question of law, namely, that the value was established by the price named in the option agreement.

CONCLUSION

It is respectfully submitted that the decision of the court below on this issue should be affirmed.

STANLEY REED,
Solicitor General.
FRANK J. WIDEMAN,
Assistant Attorney General.
GOLDEN W. BELL,
Assistant Solicitor General.
ELLIS N. SLACK,
Special Assistant to the Attorney General.
JOHN R. BENNEY,
Attorney.

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